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DEPARTMENT OF AUDITOR-CONTROLLER

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To: David E. Janssen
Chief Administrative Officer

Anita M. Bock, Director
Department of Children and Family Services

From: J. Tyler McCauley
Auditor-Controller

Subject: **Department of Children and Family Services Accounts Receivable Write-off of $5.3 Million related to the MacLaren Children's Center**

At the request of the Chief Administrative Office (CAO) and the Department of Children and Family Services (DCFS), my office reviewed DCFS' write-off in December 2001 of a $5.3 million receivable from the California Department of Social Services (CDSS) related to the reimbursement of DCFS administrative costs at MacLaren Children's Center (MCC).

Background

For Fiscal Years (FYs) beginning July 1, 1978, and continuing through June 30, 1992, CDSS audited DCFS' administrative claims of the MCC program. The State found that DCFS inappropriately claimed reimbursement for salary costs of Children Treatment Counselors (CTCs) beyond fourteen days per child, on the basis of the State's view that CTC's were not social workers. CDSS stated that the regulations permitted DCFS to claim only salaries of social workers beyond the 14-day period. DCFS believed that CTCs were social workers, which was contrary to the view of the State.

DCFS contested the audit finding through the administrative dispute process through the early and mid 1990s, but CDSS continued to disallow the costs. In September 1990, DCFS filed a petition in Superior Court challenging the State's 1990 administrative ruling upholding the CTC disallowances.

During the course of these protracted legal proceedings, the State withheld the disputed amount of $5.3 million for FYs 1984 through 1988, from the Department's FY 1996-97 April advance. In June 1997, DCFS established the $5.3 as a receivable from CDSS on its books. In January 2001, the Superior Court ruled in favor of CDSS and all appeals had been exhausted. In December 2001, the Department wrote off the $5.3 million receivable.

Scope and Objectives

Our review included an examination of the accounting entries through which DCFS established the $5.3 million receivable, including entries used to account for advances from the State, DCFS reimbursement claims, and recognition of revenue. We also examined other accounts in DCFS' Welfare Advancement Fund that were carrying receivable balances to determine if other receivable balances remained inappropriately on the Department's books.

Details of our findings are discussed below.

Review Summary

Generally Accepted Accounting Principles (GAAP) do not permit entities to record "contingent" receivables. Given DCFS' receipt of the $5.3 million from the State was contingent upon the Superior Court ruling in favor of DCFS, DCFS should not have established the $5.3 million receivable. DCFS did not confer with the Auditor-Controller Accounting Division regarding the proper accounting treatment for the disallowed amount, but it should have. DCFS needs to strengthen its procedures for recording and monitoring transactions affected by lawsuits or other uncertain matters that may impact the accuracy of its financial position.

We also noted that DCFS Finance needs to review its Trust Account Payable (TAP) balances at least annually, to ensure receivable balances are valid and will be collected within a one year period.

DCFS' Accounting for the MacLaren Children's Center Disallowed Costs

The specific accounting entries which DCFS made related to this issue are provided in detail on the Attachment. A brief summary of the significant entries follow.

- In April 1997, the State withheld the disallowed costs of $5.3 million from the Department's FY 1996-97 April advance, based on an Administrative Hearing decision in favor of the State.

- In May 1997, DCFS filed a second Superior Court petition against the State to recover the disputed amounts. In June 1997, the Department established a receivable for the disallowed amount. This had the effect of increasing revenue for FY 1996-97.

- In January 2001, the Superior Court ruled in favor of CDSS, which was upheld by the Court of Appeal. In December 2001, DCFS wrote off the $5.3 million. This had the effect of decreasing revenue for FY 2001-02.

DCFS established the receivable in June 1997 based on County Counsel's opinion that there was a 25% to 75% chance that the Superior Court would rule in favor of DCFS.

However, DCFS did not confer with the Auditor-Controller Accounting Division regarding the proper accounting treatment for the disallowed amount. If it had, the Accounting Division would have recommended DCFS not establish the receivable because the receipt of the funds was “contingent” upon the Superior Court ruling in favor of DCFS. Generally Accepted Accounting Principles (GAAP) do not permit entities to record “contingent” receivables. DCFS should not record contingent receivables and should contact the Auditor-Controller Accounting Division for advice if the Department is unsure of the proper accounting treatment for disallowed costs.

Recommendation

1. **DCFS not record contingent receivables and contact the Auditor-Controller Accounting Division for advice if the Department is unsure of the proper accounting treatment for disallowed costs.**

Current TAP Account Review

We reviewed all Trust Account Payable (TAP) accounts as of December 31, 2001. We identified 149 accounts that contained receivable balances totaling $43.4 million from July 1, 2000 through December 31, 2001. Thirteen accounts contained receivable balances totaling $37.8 million (87% of the total balance). We selected five of the 13 accounts, totaling $21.0 million (48% of the total balance), to determine if the balances were from State disallowed claims, or claims yet to be paid by the State. All five outstanding debit balances were related to claims submitted to the State but not yet paid. Although Finance staff reconcile TAP account activity monthly to the County's accounting records, they do not generally review account balances to ensure receivable balances are still valid and will be collected within a one year period. DCFS Finance should at least annually, review all TAP account balances to ensure receivable balances are valid and will be collected within a one year period. In addition, Finance staff should write off accounts determined to be no longer valid.

Recommendation

2. **DCFS Finance review all TAP account balances at least annually to ensure receivable balances are still valid and will be collected within a one year period. In addition, Finance staff should write off accounts determined to be no longer valid.**

If you have any questions, please contact me or your staff may contact DeWitt Roberts at (213) 974-0301, or Terri Kasman at (213) 974-8475.

JTM:DR:JK:TK
Attachment

c: Board of Supervisors
Lloyd W. Pellman, County Counsel
Audit Committee

Department of Children and Family Services
MacLaren Children's Center Lawsuit - $5.3 Million Write-Off
Review of Accounting Entries

Accounting Entries

Following are the accounting entries the Department of Children and Family Services (DCFS) made to record advances from the State, the receivable of $5,288,988 related to MacLaren Children's Center disallowed costs, amounts claimed, and the write-off of the receivable. In addition, we have included the entries DCFS should have made to appropriately account for these funds.

<u>Auditor-Controller Receives the Fiscal Year 1996-97 April Advance</u>

April 1997

1. Cash (S31)	$14,430,465	
Advance Payable (S31)		$14,430,465

This entry recorded the receipt of $14,430,465 cash from the State for the administration of various programs [i.e., MacLaren Children's Center (MCC), Adoptions, Aid to Families with Dependent Children (AFDC), Child Welfare Services (CWS)] under DCFS' control. The cash amount received is net of the advance amount due (i.e., $19,719,453) by $5,288,988. The State reduced the advance by $5,288,988 due to disallowed costs resulting from the MCC lawsuit.

Upon receipt of the funds, the Auditor-Controller (A-C) credited Advances Payable in the Welfare Advancement Fund (i.e., Fund S31). Once they have identified the specific accounts within each program to credit, DCFS transfers the funds from Advances Payable to each specific Trust Account Payable (TAP) subsidiary account (see entry #3).

2. Cash (A01)	$14,430,465	
Due to WAF (A01)		$14,430,465
Due from GF (S31)	$14,430,465	
Cash (S31)		$14,430,465

This entry transferred cash received from the Welfare Advancement Fund to the General Fund (i.e., Fund A01), so the Department could begin to incur program expenditures. The Welfare Advancement Fund does not account for revenues and expenditures. It accounts solely for amounts received and amounts claimed for each program in the Welfare Advancement Fund.

DCFS Allocates Advance to Individual Programs

June 1997

3. Advance Payable (S31)	$14,430,465	
General Suspense #5TC4 (S31)	$ 5,288,988	
Adoptions #5T36 (S31)		$ 327,500
Adoptions #5T40 (S31)		$ 944,800
AFDC #5T52 (S31)		$1,682,100
ADFC #5T56 (S31)		$1,160,100
CWS federal #5T60 (S31)		$6,725,600
CWS State # 5T64 (S31)		$8,303,200
Family Preservation federal #5T72 (S31)		$ 576,153

Upon State notification of individual program allocations, DCFS reduced Advances Payable in the Welfare Advancement Fund by the amount the account was credited for in entry #1 ($14,430,465), and recorded deferred revenue for each specific TAP account affected by the advance. The Department recorded the difference [i.e., the difference between the full advance ($19,719,453) and the actual cash advanced ($14,430,465)] as a receivable (i.e., General Suspense) in the Welfare Advancement Fund, pending finalization of the lawsuit. DCFS classifies amounts as deferred revenue in the Welfare Advancement Fund until their final claim has been prepared, indicating that they have incurred expenditures and earned revenue.

DCFS established the receivable in June 1997 based on County Counsel's opinion that there was a 25% to 75% chance that the Superior court would rule in favor of DCFS. However, DCFS did not confer with the Auditor-Controller Accounting Division regarding the proper accounting treatment for the disallowed amount. If it had, the Accounting Division would have recommended DCFS not establish the receivable.

Given that the Department did establish a receivable, they should have taken the following additional steps:

- Governmental accounting policies state an entity may not recognize revenue unless it is both measurable (i.e., the amount is known) and available (i.e., received within 12 months). In this case, the likelihood of the lawsuit yielding a favorable outcome within the next 12 months appeared questionable. Accordingly, the Department should have established a corresponding liability to offset the receivable until the lawsuit was resolved.

- The Department should have reduced Prior Year Revenue by the $5,288,988 withheld by the State. DCFS received this amount in a prior year, but the State disallowed these costs. Not doing so will result in an overstatement of prior year revenue.

- DCFS should have established Due to and Due From entries for $5,288,988. By not doing so, the Due to and Due From accounts are overstated by $5,288,988, which is the amount disallowed by the State and pending finalization of the lawsuit.

Entry #4 below reflects what the Department should have done at the time they received the allocation letter from the State.

4. Advance Payable (S31)	$14,430,465	
General Suspense #5TC4 (S31)	$ 5,288,988	
Adoptions #5T36 (S31)		$ 327,500
Adoptions #5T40 (S31)		$ 944,800
AFDC #5T52 (S31)		$1,682,100
ADFC #5T56 (S31)		$1,160,100
CWS federal #5T60 (S31)		$6,725,600
CWS State # 5T64 (S31)		$8,303,200
Family Preservation federal #5T72 (S31)		$ 576,153
Prior Year Revenue (A01)	$ 5,288,988	
TAP Subsidiary – liability (S31)		$ 5,288,988
Due from GF (S31)	$ 5,288,988	
Due to WAF (A01)		$ 5,288,988

DCFS Submits 4th Quarter Claim to the State

December 1997

5. TAP Subsidiary (S31)	$22,550,000	
Collected Revenue		$19,719,453
Accrued Revenue		$ 2,830,547
Due to WAF (A01)	$22,550,000	
Due from GF (S31)		$22,550,000

Upon submitting their 4th quarter claim, DCFS debited the TAP Subsidiary accounts (i.e., deferred revenue) in an amount equal to expenditures claimed, and credited Collected Revenue for the unadjusted advance amount. Since the claim amount was greater than the amount advanced, the Department credited Accrued Revenue for the difference, pending the State's review and approval of the final claim. These entries have the effect of reducing deferred revenue (a liability), and recognizing revenue to the extent Departmental expenditures had been incurred.

The Department also reduced the Due from General Fund and the Due to Welfare Advancement Fund by the amount of their claim, $22,550,000. These postings, combined with those from entry #2 and #4, result in debit (receivable) and credit (payable) balances of $2,830,547, in the Due to Welfare Advancement Fund (General Fund) and the Due from General Fund (Welfare Advancement Fund) accounts, respectively. In effect, these postings indicate that because the General Fund "covered" the $22,550,000 in expenditures, a balance of $2,830,547 remains due to the General Fund.

<u>DCFS Reclassifies the MCC Receivable</u>

March 1998

6. MacLaren Appeal 84-88 #5UG6(S31)	$5,288,988	
General Suspense #5TC4(S31)		$5,288,988

DCFS reclassified the amounts from the General Suspense account to an account that more closely described the purpose and nature of the funds.

<u>DCFS Writes-Off the MCC Disallowed Costs</u>

December 2001

7. Prior Year Revenue	$5,288,988	
Due to WAF (A01)		$5,288,988
Due from GF (S31)	$5,288,988	
MacLaren Appeal FY 84-88 #5UG6(S31)		$5,288,988

Upon notification of the unfavorable verdict, the Department wrote off the receivable by crediting account #5UG6 (MacLaren Appeal). In addition, they reduced Prior Year Revenue, acknowledging the Department would need to use the $5,288,988 received in a prior year, but disallowed by the State, to cover current year expenditures. The Department also increased the Due to Welfare Advancement Fund and the Due From General Fund accounts, resulting in debit and credit balances of $2,830,547, respectively. In effect, these balances indicate that because the General Fund "paid for" or "covered" the expenditures incurred, the Welfare Advancement Fund must reimburse the General Fund for any remaining balances paid by the State upon approval of the Department's final claim.

Overall, except for the timeliness with which this entry was prepared (i.e., December 2001), the entry is correct. The Department should have taken a more active role in monitoring the progress of the lawsuit, in which case they would have known the court decided the lawsuit in January 2001.

Entry #8 below reflects what the Department should have done as soon as possible after the court decided the lawsuit:

8. TAP Subsidiary (S31) $5,288,988 MacLaren Appeal FY 84-88 #5UG6(S31)$5,288,988	

Had the Department correctly established a liability as recommended in entry #4, they would have to reduce the outstanding liability and the receivable upon notification that the MCC lawsuit resulted in an unfavorable outcome (i.e., our recommended entry #8 would replace the Department's entry #7).